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UNITED DRUG, INC.

AND

SUBSIDIARY COMPANIES

ANNUAL REPORT

DECEMBER 31, 1935

March 7, 1936.

To the Stockholders of United Drug, Inc.:

The Annual Report of your Company is herewith submitted, presenting a consolidated balance sheet, profit and loss statement and surplus reconciliation, together with statement of general reserve and reserve for contingencies, for the year ending December 31, 1935.

After providing for depreciation, Federal taxes, bond interest and loss on guaranteed leases, earnings for 1935 amounted to $1,504,517.64, which is $1.07 per share on the capital stock of the Company. This amount, however, included extraordinary income of $605,160.97 and extraordinary deductions of $455,337.70, as per the accompanying statement of profit and loss.

Earned surplus as of December 31, 1935 amounted to $4,374,347.71.

It will be noted from the balance sheet that total current assets amounted to $33,965,-949.98, of which amount cash, call loans and marketable securities totalled $11,716,180.51.

The Company had in its treasury, bonds amounting to $2,524,300 as of December 31, 1935, an amount approximately equal to the amount held in its treasury as of December 31, 1934, and sufficient to take care of over three years' sinking fund requirements. During 1935 $750,000 of bonds were retired. In addition there were retired the entire issue of First Mortgage Bonds of United Chocolate Refiners, Inc., a subsidiary, amounting to $425,000.

In the Annual Report for 1934 a policy was announced relative to the carrying of store fixtures of the domestic retail companies at a nominal amount, together with a method of accounting for additions and replacements thereof. This method of accounting has been continued through 1935, and substantial charges for maintenance and replacement of such assets, and for additional equipment purchased, have been made to operations on a basis comparable with 1934.

On December 31, 1935 the rehabilitation of the domestic retail companies was substantially completed. Recognizing this, and believing that a more orthodox basis of accounting should be adopted, the Company's accountants, Messrs. Price, Waterhouse & Co., recommended that adjustments be made as of that date so that store fixtures and improvements would be carried at values more reflective of their worth to the reorganized businesses than the nominal values heretofore used. In acceptance of this recommendation, valuations have been set up on the books in respect of store fixtures and improvements of the domestic retail companies, based principally on appraisals made by the Trustees in Bankruptcy from whom they were acquired in 1933 and 1934, plus subsequent additions at cost. Beginning in 1936, following the further recommendation of Price, Waterhouse & Co., it is proposed to capitalize the cost of new additions, and to provide for depreciation on valuations established, at rates based on estimates of the useful life of the assets. Although the former method was found to be satisfactory during the period of rehabilitation, this change in accounting procedure will tend to eliminate marked fluctuations in earnings in years in which store openings vary from normal.

The effect of these adjustments on the consolidated balance sheet as of December 31, 1935 has been to increase the amount of store fixtures and improvements by $6,058,708.83. Against this amount, reserves for depreciation and amortization of $2,404,021.02 have been provided, resulting in a net increase in property accounts amounting to $3,654,687.81. The general reserve account has been eliminated, as explained in the accompanying statement, and capital surplus has been increased in the amount of $3,574,104.24.

It is expected that the Directors at the Annual Meeting will authorize that the capital surplus thus created, together with the former balance in the account, be used to write off a portion of the consolidated goodwill account.

During the past year the management of your Company has devoted its efforts to restoring volume of business lost during depression years. Vigorous and aggressive action has been taken by both manufacturing and retail units to recover some of the lost ground from the volume standpoint. That we have met with some success is shown by the fact that combined net sales, after eliminating all inter-company sales, discounts, sales taxes, etc., showed a gain of $4,300,271.61 over 1934. While this increased effort to build up volume was accompanied by some increased expense in all companies, we feel confident that we have created an upward trend in our volume which will be permanent.

While the retail companies were profitable in 1935 as in 1934, they had to face price disturbances due to the passing of the N. R. A., which, coupled with unsettled trade conditions in many sections, materially reduced retail gross profits. These factors, together with an increase in various types of taxes and licenses, caused earnings to be lower for the year than in 1934. As an illustration, sales taxes alone in our retail companies showed an increase of $192,000 in 1935.

The new Research laboratory, referred to in the 1934 Annual Report, has been completed and opened as of January 1, 1936. It is the most modernly equipped research laboratory that we know of in our line of industry. We are already feeling the benefits of its activities. During the past month ten entirely new items have been developed and approved by the Formula Committee for manufacture. Results of our new Survey Department, in aiding the Rexall Agents to improve their merchandising efforts, have been gratifying.

During 1935 large sums of money were expended in various forms of advertising in an effort to promote the exclusive agency plan. At this moment plans have been perfected to contact personally our Rexall Agents and to determine the results and benefits of the various forms of advertising for future guidance. We are planning to send throughout the country a Rexall Convention Train, specially constructed and leased to us by The Pullman Company. This train will have convention halls, and also cars in which all products manufactured by your Company will be on display. The Executive Officers of your Company will travel in relays on the train, and local conventions will be held in more than one hundred cities and towns in the United States and Canada, besides many stop-overs. Personal contact will be made with over ninety per cent of our Rexall Agents. At that time we will determine if the money spent in advertising in 1935 accomplished the purpose for which it was spent and will ascertain if there are any improvements to be made which will enable us to eliminate non-effective forms of advertising, and increase the expenditure on effective forms. The expense of this train will be absorbed by the cancelling of all State Club and National Conventions which we had planned to hold in 1936.

Permanent registration on the New York Stock Exchange was effected as of July 1, 1935 under the Securities Exchange Act of 1934.

Respectfully,

Louis K Liggett

President.

PRICE, WATERHOUSE & CO.

75 FEDERAL STREET

BOSTON

February 25, 1936.

To the Board of Directors of
United Drug, Inc.:

We have made an examination of the consolidated balance sheet of United Drug, Inc. and its subsidiary companies as at December 31, 1935, and of the consolidated statement of profit and loss and earned surplus and statement of general reserve and reserve for contingencies for the year ending on that date. In connection therewith, we examined or tested accounting records and other supporting evidence and obtained information and explanations from officers and employees of the companies; we also made a general review of the accounting methods and of the operating and income accounts, but we did not make a detailed audit of the transactions. We have been furnished with accounts of United Drug Company, Limited (England), a wholly owned subsidiary, which have been certified by other public accountants.

The accompanying statement of profit and loss includes a provision for replacement of fixtures and equipment, etc. of Liggett Drug Company, Inc. and The Owl Drug Co., in lieu of depreciation, on a basis consistent with the provision in 1934. As at December 31, 1935 these companies discontinued their previous policy of carrying fixtures and equipment at nominal amounts and these assets are reflected in the accompanying consolidated balance sheet at amounts based principally on valuations placed thereon by the Trustees in Bankruptcy from whom they were acquired in 1933 and 1934, plus subsequent additions at cost, as approved by the directors of the companies. Commencing on January 1, 1936 it is planned to provide for depreciation of such fixtures and equipment based upon the valuations now assigned to them. In our opinion, if the proposed policy in regard to depreciation had been effected as at the beginning of 1935 the earnings for that year would not have been reduced thereby.

In our opinion, based upon such examination and subject to the above comments and explanations and the acceptance of the accounts of United Drug Company, Limited (England), as certified by other public accountants, the accompanying consolidated balance sheet and related statement of profit and loss and earned surplus and statement of general reserve and reserve for contingencies fairly set forth the position of United Drug, Inc. and its subsidiary companies at December 31, 1935, and the result of their operations for the year ending on that date.

PRICE, WATERHOUSE & CO.

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CONSOLIDATED BALANCE S

ASSETS

CURRENT ASSETS:			
Cash in banks and on hand		$10,011,070.97	
Short term and call loans		570,000.00	
Miscellaneous marketable securities (*value based on December 31, 1935 market quotations—approximately $2,276,000*)		1,135,109.54	
Accounts and notes receivable:			
Customers' accounts and notes	$4,201,779.28		
Miscellaneous	559,664.48		
	$4,761,443.76		
Less—Reserve for doubtful accounts and notes, discounts, etc.	486,469.84	4,274,973.92	
Inventories of merchandise, partly finished stocks, materials and supplies, certified as to quantities and condition by responsible officials (*at cost, not exceeding market*)		17,974,795.55	$33,965,949.98
INVESTMENTS AND ADVANCES, ETC.:			
Customers' notes receivable and advances, less reserve		$ 358,216.59	
Miscellaneous advances, claims, and deposits, less reserves (including $77,713.41 due from employees)		718,740.64	
Advances to affiliated company		100,000.00	
Miscellaneous investments, at or below cost		502,345.03	1,679,302.26
CAPITAL STOCK OF UNITED DRUG, INC.—31,261 shares owned by subsidiary company, at cost			339,919.62
PROPERTY ACCOUNTS—at cost, written down amounts, or appraisal valuations (*including store fixtures and improvements to leaseholds of Liggett Drug Company, Inc. and The Owl Drug Co. at amounts based principally on valuations placed thereon in 1933 by Trustees in Bankruptcy and approved by the Directors, plus subsequent additions at cost*):			
Land, buildings, and building fixtures		$ 8,663,800.97	
Machinery and equipment, etc.		8,343,175.81	
Store fixtures and improvements		6,481,264.47	
		$23,488,241.25	
Less—Reserve for depreciation and amortization		10,522,108.52	12,966,132.73
PREPAID INSURANCE, TAXES, RENT, ETC., AND ADVERTISING SUPPLIES			581,040.47
GOODWILL, TRADE-MARKS, ETC.			10,401,169.38
			$59,933,514.44

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HEET—DECEMBER 31, 1935

LIABILITIES

CURRENT LIABILITIES:		
Accounts payable, accrued expenses, etc.	$ 5,775,989.93	
Accrued interest on funded debt	524,645.62	
Amount owing to affiliated company	6,528.90	
Provision for federal and foreign income taxes	348,637.96	$ 6,655,802.41
FUNDED DEBT:		
Twenty-five year 5% debenture bonds of United Drug Company, due March 15, 1953:		
Authorized and issued, $40,000,000, less $1,500,000 retired	$38,500,000.00	
Less—In treasury, held for retirement (*including $750,000 principal amount available to meet the sinking fund payment due March 15, 1936*)	2,524,300.00	35,975,700.00
RESERVES FOR:		
Miscellaneous deferred income, etc.	$ 141,064.81	
Maintenance of store fixtures and improvements, provided for out of income with the exception of $50,000 transferred from the general reserve	227,840.28	
(*Note*: Reserves for replacement of fixtures and equipment as at December 31, 1934, have been transferred to the reserve for depreciation and amortization of property accounts.)		
Contingencies—per accompanying statement	1,674,574.64	2,043,479.73
CAPITAL STOCK:		
Authorized and issued, or to be issued—1,400,560 shares, par value $5 each		7,002,800.00
CAPITAL SURPLUS:		
Balance, December 31, 1934	$ 307,280.35	
Amount transferred from general reserve account as of December 31, 1935, per accompanying statement	3,574,104.24	3,881,384.59
EARNED SURPLUS, representing net earnings of United Drug Company and subsidiary companies since September 1, 1933 which have not been distributed to the parent company, United Drug, Inc. (*including $563,857.43 of earnings of United Drug Company which have been allocated to capital surplus on its books*)—per accompanying statement		4,374,347.71
CONTINGENT LIABILITY:		
For portion of such liabilities as may result to Drug Incorporated.		
		$59,933,514.44

UNITED DRUG, INC.
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF PROFIT AND LOSS AND EARNED SURPLUS FOR THE YEAR ENDING DECEMBER 31, 1935

Sales, less returns, allowances and discounts		$82,739,760.33
Cost of goods sold, selling, general, and administrative expenses (*including depreciation of $573,769.70 and, in lieu of depreciation for domestic retail companies, provision for replacement of fixtures and equipment, etc. amounting to $611,157.09*)		79,348,642.04
Profit from operations		$ 3,391,118.29
Other income:		
Income from investments	$ 101,170.83	
Interest on bank balances, notes receivable, etc.	47,990.46	
Miscellaneous	16,085.02	165,246.31
		$ 3,556,364.60
Other charges and income taxes:		
Interest on funded debt	$1,834,121.85	
Provision for federal and foreign income taxes	353,991.01	
Miscellaneous	13,557.37	2,201,670.23
Profit for the year before extraordinary income and charges		$ 1,354,694.37
Extraordinary income and charges:		
Excess of proceeds from the sale of investments over book value thereof	$ 356,629.31	
Recovery of claims against Liggett and Owl bankrupt estates in excess of amounts at which such claims were valued at the time United Drug, Inc. was organized in 1933	248,531.66	
	$ 605,160.97	
Deduct:		
Loss from operation of leases acquired by United Drug Company, as guarantor, from Louis K. Liggett Company, bankrupt	455,337.70	149,823.27
Net profit for the year		$ 1,504,517.64
Consolidated earned surplus balance, December 31, 1934	$2,690,197.35	
Discount on bonds acquired during the year of United Drug Company and United Chocolate Refiners, Inc., wholly owned subsidiaries	179,632.72	2,869,830.07
Consolidated earned surplus balance, December 31, 1935, carried to balance sheet		$ 4,374,347.71

UNITED DRUG, INC.
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF GENERAL RESERVE AND RESERVE FOR CONTINGENCIES FOR THE YEAR ENDING DECEMBER 31, 1935

GENERAL RESERVE

Balance, December 31, 1934 (carried on books of Liggett Drug Company, Inc. and The Owl Drug Co.)		$1,775,783.55
Deduct:		
Expenditures made during 1935 in connection with the rehabilitation of the "Liggett" and "Owl" chains of drug stores, including the cost of new stores, replacing old stores, enlarging or otherwise rebuilding existing stores, etc.	$1,383,104.78	
Other charges and miscellaneous adjustments (*net*)	58,692.18	
	$1,441,796.96	
Less—Recoveries in respect of claims against bankrupt companies—not previously reflected in the accounts	214,861.24	1,226,935.72
		$ 548,847.83
Add:		
Net credit to the general reserve resulting from valuations taken up on the books in respect of store fixtures and improvements as at December 31, 1935, including the cost of store fixtures and improvements acquired and other rehabilitation expenditures, etc. during the years 1933, 1934, and 1935 which were charged to the general reserve		4,433,022.06
Balance		$4,981,869.89
Disposed of as follows in connection with the discontinuance of the companies' previous policies relating to the general reserve and the valuation of store fixtures and equipment of retail companies:		
Transferred to—		
Reserve for maintenance, to cover estimated deferred maintenance of The Owl Drug Co.	$ 50,000.00	
Reserve for contingencies, to cover possible adjustments in initial valuations placed on assets, other charges, etc. relating to the acquisition in 1933 and 1934 of the retail companies	1,357,765.65	
Capital surplus	3,574,104.24	$4,981,869.89

RESERVE FOR CONTINGENCIES

Balance, December 31, 1934	$ 271,808.99
Amounts transferred from:	
General reserve, as explained above	1,357,765.65
Reserve for expansion, provided for out of income in 1934	100,000.00
	$1,729,574.64
Deduct—Provision for settlement of lawsuit of subsidiary company, which originated in 1928	55,000.00
Balance, December 31, 1935, carried to balance sheet	$1,674,574.64

OFFICERS

Louis K. Liggett	*President*
George M. Gales	*Vice-President*
J. A. Galvin	*Secretary and Treasurer*
W. Newlin Mitchell	*Assistant Treasurer*

DIRECTORS

Charles Francis Adams	*President*, The Union Trust Company of Boston, Boston
George M. Gales	*President*, Liggett Drug Company, Inc., New York
George C. Haigh	*Vice-President*, Bank of the Manhattan Company, New York
Louis K. Liggett	*President*, Boston
Warren Motley	Gaston, Snow, Saltonstall, Hunt and Rice, Boston
Charles S. Munson	*President*, U. S. Industrial Alcohol Company, New York *Vice-President and Director*, Air Reduction Co., Inc., New York
James L. Richards	*Chairman Board of Trustees*, Massachusetts Gas Companies, Boston
Fred S. Rogers	of McMonagle and Rogers, Inc., Middletown, New York
Eugene W. Stetson	*Vice-President*, Guaranty Trust Company of New York, New York

Transfer Agents

Guaranty Trust Company of New York, New York
The Union Trust Company of Boston, Boston

Registrars

The Chase National Bank of the City of New York, New York
The National Shawmut Bank of Boston, Boston

Counsel

Gaston, Snow, Saltonstall, Hunt and Rice, Boston
Root, Clark, Buckner and Ballantine, New York